

1996

Monitoring a CPA firm's accounting and auditing practice; Statement on quality control standards 3

American Institute of Certified Public Accountants. Auditing Standards Board

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American Institute of Certified Public Accountants. Auditing Standards Board, "Monitoring a CPA firm's accounting and auditing practice; Statement on quality control standards 3" (1996). *AICPA Professional Standards*. 261.
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Statement on Quality Control Standards

Issued by the Auditing Standards Board

May 1996

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American Institute of Certified Public Accountants

Monitoring a CPA Firm's Accounting and Auditing Practice

Introduction

1. This Statement provides guidance on how a CPA firm implements the monitoring element of a quality control system in its accounting and auditing practice.¹

2. Statement on Quality Control Standards No. 2, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*, describes *Monitoring* as one of the five elements of quality control. It provides that a CPA firm² should establish policies and procedures to provide the firm

¹ *Accounting and auditing practice* refers to all audit, attest, accounting and review, and other services for which standards have been established by the AICPA Auditing Standards Board or the AICPA Accounting and Review Services Committee under rule 201 or 202 of the AICPA Code of Professional Conduct (AICPA, *Professional Standards*, vol. 2, ET secs. 201 and 202). Standards may also be established by other AICPA senior technical committees; engagements that are performed in accordance with those standards are not encompassed in the definition of an accounting and auditing practice.

² A *firm* is defined in the AICPA Code of Professional Conduct as "a form of organization permitted by state law or regulation whose characteristics conform to resolutions of Council that is engaged in the practice of public accounting, including the individual owners thereof" (AICPA, *Professional Standards*, vol. 2, ET sec. 92.05).

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with reasonable assurance that the policies and procedures relating to each of the other elements of quality control are suitably designed and are being effectively applied. Monitoring involves an ongoing consideration and evaluation of the—

- a. Relevance and adequacy of the firm's policies and procedures.
- b. Appropriateness of the firm's guidance materials and any practice aids.
- c. Effectiveness of professional development activities.
- d. Compliance with the firm's policies and procedures.

When monitoring, the effects of the firm's management philosophy and the environment in which the firm practices and its clients operate should be considered.

Monitoring Procedures

3. Monitoring procedures taken as a whole should enable the firm to obtain reasonable assurance that its system of quality control is effective. Procedures that provide the firm with a means of identifying and communicating circumstances that may necessitate changes to or the need to improve compliance with the firm's policies and procedures contribute to the monitoring element. A firm's monitoring procedures may include—

- Inspection procedures. (See paragraphs 4 through 7.)
- Preissuance or postissuance review of selected engagements. (See paragraphs 8 and 9.)
- Analysis and assessment of —
 - New professional pronouncements.
 - Results of independence confirmations.
 - Continuing professional education and other professional development activities undertaken by firm personnel.³
 - Decisions related to acceptance and continuance of client relationships and engagements.
 - Interviews of firm personnel.

³The term *personnel* refers to all individuals who perform professional services for which the firm is responsible, whether or not they are CPAs.

- Determination of any corrective actions to be taken and improvements to be made in the quality control system.
- Communication to appropriate firm personnel of any weaknesses identified in the quality control system or in the level of understanding or compliance therewith.
- Follow-up by appropriate firm personnel to ensure that any necessary modifications are made to the quality control policies and procedures on a timely basis.

4. Inspection procedures evaluate the adequacy of the firm's quality control policies and procedures, its personnel's understanding of those policies and procedures, and the extent of the firm's compliance with its quality control policies and procedures. Inspection procedures contribute to the monitoring function because findings are evaluated and changes in or clarifications of quality control policies and procedures are considered.

5. The need for and extent of inspection procedures depends in part on the existence and effectiveness of the other monitoring procedures. Factors to be considered in determining the need for and extent of inspection procedures include, but are not limited to —

- The nature, complexity, and diversity of, and the risks associated with, the firm's practice.
- The firm's size, number of offices, degree of authority allowed its personnel and its offices, and organizational structure.
- The results of recent practice reviews⁴ and previous inspection procedures.
- Appropriate cost-benefit considerations.⁵

6. The nature of inspection procedures will vary based on the firm's quality control policies and procedures and the effectiveness and results of other monitoring procedures. The adequacy of and compliance with

⁴Practice reviews include, but are not limited to, peer reviews performed under standards established by the AICPA and reviews conducted by regulatory agencies.

⁵Although appropriate cost-benefit considerations may be considered in determining the need for and extent of inspection procedures, a firm must still effectively *monitor* its practice.

a firm's quality control system are evaluated by performing such inspection procedures as —

- Review of selected administrative and personnel records pertaining to the quality control elements.
- Review of engagement working papers, reports, and clients' financial statements. (See also paragraphs 8 and 9.)
- Discussions with the firm's personnel.
- Summarization of the findings from the inspection procedures, at least annually, and consideration of the systemic causes of findings that indicate improvements are needed.
- Determination of any corrective actions to be taken or improvements to be made with respect to the specific engagements reviewed or the firm's quality control policies and procedures.
- Communication of the identified findings to appropriate firm management personnel.
- Consideration of inspection findings by appropriate firm management personnel who should also determine that any actions necessary, including necessary modifications to the quality control system, are taken on a timely basis.

Inspection procedures with respect to the engagement performance element of a quality control system are particularly appropriate in a firm with more than a limited number of management-level individuals⁶ responsible for the conduct of its accounting and auditing practice.

7. Inspection procedures may be performed at a fixed time(s) during the year covering a specified period(s) of time or as part of ongoing quality control procedures, or a combination thereof.

8. Procedures for carrying out preissuance or postissuance review of engagement working papers, reports, and clients' financial statements by a qualified management-level individual (or by a qualified individual under his or her supervision) may be considered part of the firm's monitoring procedures provided that those performing or supervising such preissuance or postissuance reviews are *not directly associated with*

⁶The term *management-level individual* refers to all owners of a firm and other individuals within the firm with a managerial position as described in Interpretation 101-9 of the Code of Professional Conduct (AICPA, *Professional Standards*, vol. 2, ET sec. 101.11).

the performance of the engagement. Such preissuance or postissuance review procedures may constitute inspection procedures provided—

- a. The review is sufficiently comprehensive to enable the firm to assess compliance with all applicable professional standards and the firm's quality control policies and procedures.
- b. Findings of such reviews that may indicate the need to improve compliance with or modify the firm's quality control policies and procedures are periodically summarized, documented, and communicated to the firm's management personnel having the responsibility and authority to make changes in those policies and procedures.
- c. The firm's management personnel consider on a timely basis the systemic causes of findings that indicate improvements are needed and determine appropriate actions to be taken.
- d. The firm implements on a timely basis such planned actions, communicates changes to personnel who might be affected, and follows up to determine that the planned actions were taken.

A preissuance and, except as described in paragraph 9, a postissuance review of engagement working papers, reports, and clients' financial statements by the person with final responsibility for the engagement does not constitute a monitoring procedure.

9. In small firms with a limited number of qualified management-level individuals, postissuance review of engagement working papers, reports, and clients' financial statements by the person with final responsibility for the engagement may constitute inspection procedures, provided the provisions in paragraphs 8a–d are followed. (See also paragraph 11.)

Monitoring in Small Firms With a Limited Number of Management-Level Individuals

10. In small firms with a limited number of management-level individuals, monitoring procedures may need to be performed by some of the same individuals who are responsible for compliance with the firm's quality control policies and procedures. To effectively monitor one's own compliance with the firm's policies and procedures, an individual must be able to critically review his or her own performance, assess his

or her own strengths and weaknesses, and maintain an attitude of continual improvement. Changes in conditions and in the environment within the firm (such as obtaining clients in an industry not previously serviced or significantly changing the size of the firm) may indicate the need to have quality control policies and procedures monitored by another qualified individual.

11. The performance of inspection procedures in firms with a limited number of management-level individuals can assist the firm in the monitoring process. An individual inspecting his or her own compliance with a quality control system may be inherently less effective than having such compliance inspected by another qualified individual. When one individual inspects his or her own compliance, the firm may have a higher risk that noncompliance with policies and procedures will not be detected. Accordingly, a firm in this circumstance may find it beneficial to engage a qualified individual from outside the firm to perform inspection procedures.

The Relationship of Peer Review to Monitoring

12. A peer review does not substitute for monitoring procedures. However, since the objective of a peer review is similar to that of inspection procedures, a firm's quality control policies and procedures may provide that a peer review conducted under standards established by the AICPA may substitute for some or all of its inspection procedures for the period covered by the peer review.

Effective Date

13. The provisions of this Statement are applicable to a CPA firm's system of quality control for its accounting and auditing practice as of January 1, 1997.

This Statement entitled Monitoring a CPA Firm's Accounting and Auditing Practice was adopted unanimously by the fifteen members of the board.

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The board gratefully acknowledges the Joint Task Force on Quality Control Standards for its significant contribution.

Note: *Statements on Quality Control Standards are issued by the Auditing Standards Board. Firms that are enrolled in an Institute-approved practice-monitoring program are obligated to adhere to quality control standards established by the Institute.*

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